

# Delivering a Step Change in Affordable Housing Supply



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Any views expressed, errors or admissions are the authors' own.

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# Foreword

This paper is a very timely exploration of a number of interlinked issues around securing a sustainable increase in the supply of affordable housing in the UK.



Set within the context of ever more tightly constrained public spending (and despite an expanded affordable housing programme) it is quite clear that output of new affordable homes is still well below what is required and is coming under further strain.

There is general agreement on this and that the social and economic costs of this continued under-provision are very substantial and growing.

Housing associations stand at the heart of affordable housing provision, so it is essential that we consider whether they have the financial capacity to deliver the required step change in supply. The paper looks in detail at the financial metrics and concludes that these are coming under real pressure, most notably the income cover ratio.

While many would reach for the subsidy solution as the way to deal with this, as history tell us, subsidy levels have plummeted over the decades and not least since the private finance regime came into being in the 1980s. The most recent Affordable Homes Programme may have delivered increased funding but a significant gap remains.

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"Housing associations stand at the heart of affordable housing provision, so it is essential that we consider whether they have the financial capacity to deliver the required step change in supply "

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Furthermore not only is the power of the cross subsidy model used in recent years to counteract reduced grant weakening, but huge new demands mainly around fire safety and decarbonisation have resulted in resources, of necessity, being spent on the existing stock rather than new build.

There is a need to face up to the sharp realities of where we are financially and where we are going in terms of delivering that step change in the supply of affordable homes. While there is a great temptation to push such problems out into the future, the costs of failure are already high, and they will be even worse if left till tomorrow.

In the 1980s we saw the successful introduction of private debt finance which helped sustain output even when grant funding was being reduced. In recent years we have seen investors re-appraise residential housing as an asset class along with the income streams that flow from it and this has opened up markets in equity investment in housing by patient capital (pension funds in the main). Student housing and Build to Rent markets would be just two examples.

As understanding and experience has grown, market appetite has developed and matured. There are now real opportunities to seriously explore equity investment in affordable homes as one of the solutions to the supply and funding gaps that exist.

The paper sets out the potential opportunities for housing associations and investors to explore collaborative models which would bring substantial new resources both for housing supply and refurbishment.

**Now is the time to consider what might be done. Please read on.**

**by Dr Peter Williams, Editor**



# Executive Summary

## Chronic and persisting undersupply of affordable housing requires a step change in approach to meet the nation's housing need.

Institutional investors have already begun to prove themselves as reliable partners in the provision of affordable housing. Their patient capital can unlock more homes and improve quality and sustainability across the board.

That said, progress is being made and there is substantial and increasing political will invested in moving the dial. Housing associations, Local authorities and developers have already shown imagination and determination in overcoming a large number of obstacles.

The challenge – 1.2 m households on social waiting lists in England, the existing model of supply cannot get close to meeting demand

However, housing associations are facing strong headwinds to development capacity not least from urgent building safety works in the shorter term, and the large-scale decarbonisation programmes required to meet the pressing climate change targets in the longer term.

**Put simply, they will need help to close the gap.**

The scale of the challenge ahead can appear daunting: there are currently 1.2m households waiting for affordable housing, and an increasing shortfall between the number of affordable homes available and the number required to meet this need.

Research for the National Housing Federation and Crisis estimates the level of housing need at 145,000 affordable homes a year compared to 52,000 delivered in 2020/21 in England. There are now nearly 100,000 households in temporary accommodation – twice the number that it was 10-years ago – and costing £1.4bn annually.

### The core problem – the funding gap

Increasing the annual supply of affordable housing will require an increase in capital funding for the sector.

**Our analysis estimates that increasing annual supply to 145,000 homes will require £34bn of additional capital funding per annum**

To date this has almost exclusively been funded through not-for-profit housing associations, local authorities, and central Government.

This picture is now changing with the entrance of institutional investors into the sector to provide the long-term funding to make the required step change in supply.

Capital investment for affordable housing consists of three elements: debt, equity, and subsidy. The third element, subsidy, is essential to make the supply of affordable housing viable. The ability of the sector to increase supply can be broken down to the availability of these three factors:

#### Debt

Readily available, however housing associations are in many cases near to borrowing limits already.



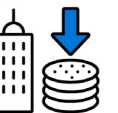
#### Equity

Housing associations do not have the ability to raise equity onto their own balance sheets due to their not-for-profit structure. Availability of equity for new development is offset by investment in existing stock, and other objectives.



#### Subsidy

The provision of capital grant is at historic low levels, with Government funding as a % of investment falling to around 20 per cent from between 50-80% in the 1990s and 2000s. Recent initiatives from the Government have reversed this long-term trend to a degree but a gap remains.



### Annual Capital Funding

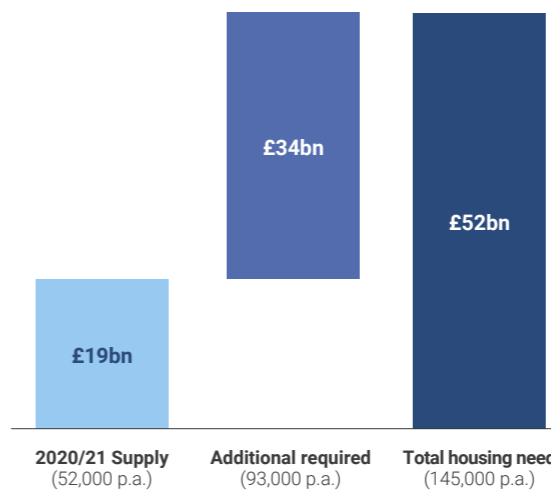


Table 1000, DLUHC, 2021

[Read more](#)



# Only new equity investment, supported by Government subsidy provision, can overcome the sector's financial limitations

Our modelling estimates that not-for-profit housing associations have a maximum long-run capacity to deliver **77,000 homes per annum in theory**, due to limits on indebtedness (interest coverage in particular). However, taking the headwinds facing the sector into account, we estimate a likely maximum of no more than **65,000 homes per annum in reality**.

Given that debt is readily available, the levels of subsidy and equity are the key funding constraints on the sector. Building 145,000 homes per annum will require c. £10bn of additional equity funding and £9-14bn of additional subsidy per annum, dependent on the tenure mix.

Other than drastically increasing the level of subsidy per unit, only new equity investment entering the sector can overcome the sector's financial limitations and deliver the step change required. Equity can reduce pressure on borrowing limits, stabilise the sector's balance sheet and spur on a truly sustainable increase in development.

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**£10bn of new equity and £9bn - £14bn of additional subsidy required per annum**

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## The solution – Partnership between Government, housing associations, and institutional investors

For-Profit Registered Providers were first permitted as a result of legislation passed in 2008 to “expand the availability of choice of provider at all levels in the provision of social housing”. The legislation allows For-Profit Registered Providers to own social housing and receive a social housing grant, enabling institutional investors to play a greater role in the provision of social and affordable housing.

The aims and objectives of institutional investors are closely aligned with the societal purposes new affordable housing provides, with investors benefitting from a long-term cashflow and households benefitting from security of tenure and high-quality affordable accommodation.

A range of partnerships are now being formed between institutional investors and housing associations which, if scaled, bring exciting opportunities to overcome the significant supply deficit and on a sustainable basis.

These partnerships bring in additional institutional capital to the sector to support the delivery of new homes and combine it with the skills, know-how and capabilities of the incumbent affordable housing providers.

### Enabling institutional investment

The analysis in this paper highlights that there is a serious and growing funding gap in the affordable housing sector. Pension funds and other institutional investors are

already beginning to fill this gap with equity as they do in other long-term housing and infrastructure areas but need support from a stable policy environment to do so.

Government can provide this support by ensuring that regulation and proper consumer, asset, viability, and governance standards are always maintained. There are idiosyncrasies between the treatment of not-for-profit providers and For-Profit Registered Providers. A more **level playing field** across the sector will encourage new investment into the sector and enable closer collaboration between housing associations and institutional investors.

**Longer-term rent settlements** would provide institutional investors with confidence to unleash inward investment into the sector. It would increase affordable housing valuations and reduce the amount of subsidy required to provide each new home irrespective of how its development is funded. This will have significant knock-on valuation benefits for housing associations. Their risk margins will fall, enabling further supply.

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**We estimate that a new 10-year rent settlement for 2025-2035 could reduce the annual subsidy requirement by c. £2bn and is a highly effective policy intervention for Government to assist in bridging the subsidy gap.**

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### Targeting subsidy provision

Provision of subsidy pays for itself many times over – it reduces the on-going and highly expensive requirement to house families in the private rented sector, and it acts as a significant enabler of increased housing output driving economic activity and job creation.

Perhaps most importantly of it all, it **provides the neediest in society with a stable roof over their heads** to go on to meet their future life aspirations and become much more economically active and self-sufficient. There now needs to be a debate around the optimal way to target this subsidy to maximise its impact.

### A way forward

The arrival and increasing appetite of institutional investors to participate in the sector presents a strong opportunity to increase the sector's overall capacity and address pressing societal needs.

### Recommendations

The arrival and increasing appetite of institutional investors to participate in the sector presents a strong opportunity to increase the sector's overall capacity and address pressing societal needs.



#### Government:

##### 1. Review the subsidy provision

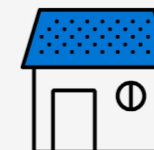
Increasing subsidy levels by £9bn - £14bn to support the delivery of 145,000 new affordable homes per annum in conjunction of a review of targeting subsidy provision. This could be through increasing grant levels, or supporting new delivery models.

##### 2. Rent settlement

Longer term rent settlements will provide investors with reassurance to spur activity, reduce the amount of risk capital required for investment and lower the subsidy requirement per unit.

##### 3. Create a level playing field

Review treatment of For-Profit Registered Providers (e.g. tax positions, grant uplift treatment) to remove obstacles for closer collaboration between institutional investors and housing associations.



#### Housing associations:

##### 1. Partnership models

Consider which models work best for the delivery of additional affordable housing and assist in achieving their other organisational goals.

##### 2. Share affordable housing expertise

Utilise their decades of experience and knowledge in affordable housing development, management to provide new high-quality affordable homes.

##### 3. Find alternatives to mergers

Weigh up partnership with institutional investors as a potentially more productive alternative to merging two capital constrained entities together.



#### Institutional investors:

##### 1. Increase capital allocations

Bring forward a greater allocation of long-term capital to support the sector as part of a diversified investment portfolio.

##### 2. Maintain a flexible approach

Structure partnerships that would work for all parties and matching to the appropriate source of capital (e.g. development risk, or stabilised assets).

##### 3. Cross-pollinate from other sectors

Institutional investors typically have a wealth of experience in adjacent sectors and can bring that to the table to aid new ventures.



The Government has made clear its intention to welcome more institutional investment into UK infrastructure.

Institutional investment has been a significant contributor to the delivery of affordable homes for the past 5 years, but it cannot grow to the level required to reach national targets without a supportive policy environment.

This paper has been led by Legal & General with significant input and support from the British Property Federation and colleagues from across numerous advisors and housing providers.

Through demystifying some of the financial and operational challenges and realities facing the participants in the affordable housing sector, it seeks to spark further informed debate around the strategic options, challenges and opportunities at both a national and local Government level as well as within the wider residential affordable housing sector itself.



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# Introduction

## Supply of affordable housing needs a three-fold increase to meet current housing need.

**General housing supply is increasing but is still significantly short of the long-term target.**

Although the Government in England has been able to significantly increase housing supply from 118,540 new build completions in 2012/13 to 194,060 per annum in 2020/21, **output is still well below its stated 300,000 per annum target.**

Given likely scenarios for the economy over the next few years, all the evidence suggests it will struggle to achieve this target. If that is the case, then the current “crisis” will be further perpetuated and with all the wider consequences that has for the economy and society as a whole.

Moreover, that gap is in all likelihood wider than the Government suggests. In part this is because of the accumulated backlog of undersupply over previous years estimated at around 1 to 1.5m homes. Research commissioned by the National Housing Federation (National Housing Federation) and Crisis from Heriot-Watt University identified a need for 340,000 homes each year to 2031, of which 145,000 “must be affordable homes”. This estimate included allowances for suppressed household formation by younger adults due to previous inadequate supply and unaffordability, as well necessary provision for more demolitions and vacancies.

The 2018 Letwin review set out to identify steps to increase the speed of build out of new housing. The paper concluded that limits on the rate at which the housing market will absorb stock is a fundamental driver of the slow rate of build. It made it very clear that housebuilders would only increase supply if they could be sure there was no prospect of reducing prices. As it stands housebuilders are managing supply and releasing it onto the market in line with sales absorption rates.

We can thus expect overall output to slow in the absence of further Government stimulus measures. Continuing shortfalls in housing delivery each annum will add to the already established backlog, raising the annual completions required and the gap between actual output and target will widen rather than close.

**Annual Affordable Housing Completions**

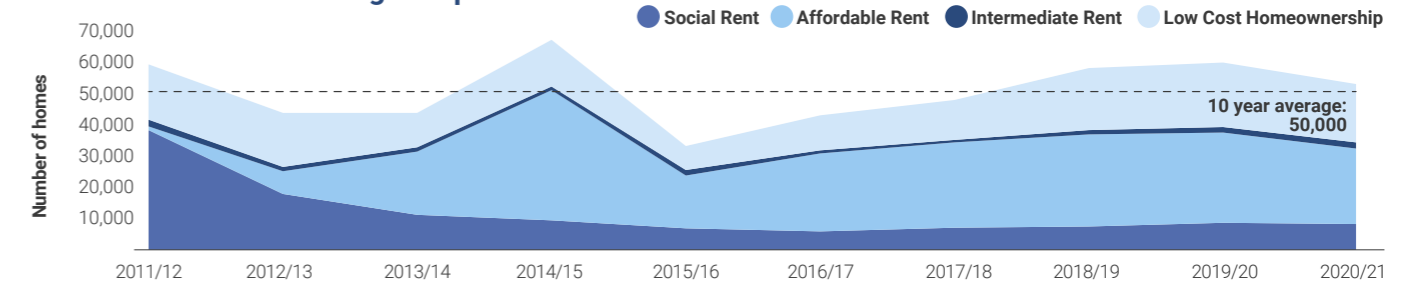


Table 1000, DLUHC, 2021

### Affordable housing supply is no different – chronic shortages continue

This problem of under-supply is even more acute when we focus on affordable housing, where through a combination of sales, conversion to the Government’s “affordable rents” regime, reductions in social rents and critically as shown later in this paper – restricted funding for new homes – actual supply on the ground is limited.

This is in the context of growing demand with 1.2m households on social housing waiting lists in England. According to a recent House of Commons briefing paper, the numbers of households in Temporary Accommodation (another measure of affordable housing pressures) has doubled from 48,010 in 2010 to 95,100 in 2021.

The size of the social housing waiting list is a proxy for the need for affordable housing but is generally considered to be an extremely low estimate following the substantial cut to criteria for eligibility to be on waiting lists in the early 2010s following the 2011 Localism Act. Updated estimates from the National Housing Federation suggest that the true number of households seeking affordable housing is closer to 1.6m.

The Bramley paper for the National Housing Federation and Crisis focussed on low income households and suggested that the estimated level of new affordable housebuilding required in England is 90,000 per annum with an additional 28,000 per annum for shared ownership (or equivalent) and 32,000 per annum for intermediate rent, giving a total of 145,000 per annum.

Similarly, the Social Housing Commission (2019) has argued that England needs to build 3.1m social homes over the next 20 years to make a “significant change” across the housing system – this translates into 155,000 new homes per annum.

The number of completions in 2020-21 has been impacted by the Covid-19 pandemic, however the **average affordable housing output (of all types including shared ownership and affordable rent) has remained in the same range over the past 10 years at 50,000 new homes per annum.**

This all suggests that there is a considerable unmet need for homes, and especially affordable housing. Meeting the supply challenge is not going to be easy; recent papers suggest that housing associations are struggling to maintain the current rate of affordable housing development let alone increase it.





# Affordable housing economics

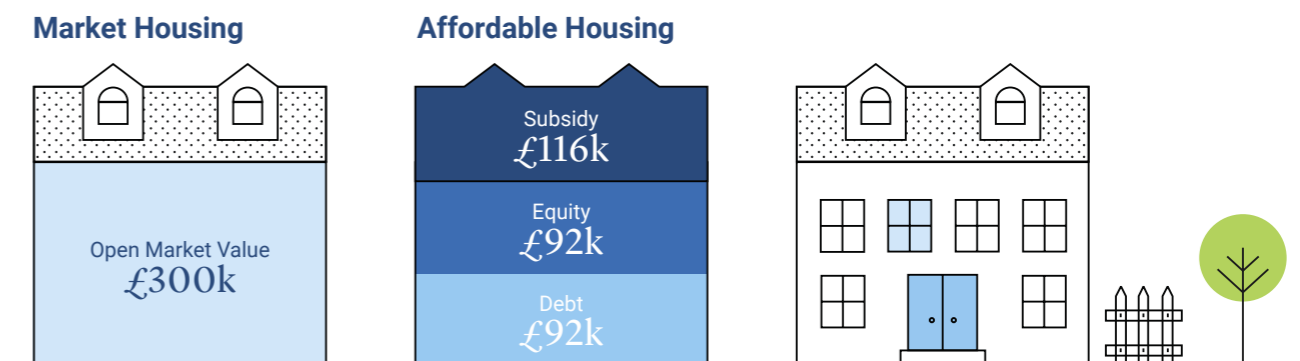
## Building on the fundamentals of corporate finance.

### Three factors of production

Research and practical application of the optimal capital structure of any market-based business has been on-going for many decades. At the most basic level, market-based activities such as building new homes require a blend of debt and equity.

On top of this, a multitude of additional practical factors are taken into account by corporates – credit rating views of the business, shareholder pressure, regulatory or Government pressures, time horizons and so forth.

This core theory can be naturally extended to any investment where sub-market returns are to be received. The difference between the market return and sub-market return would rarely be favoured by a rational investor since the return will always be inferior to the market-based options that might be available. Instead, the **provision of affordable housing requires a subsidy to be provided to the investor** to meet the value of the shortfall:



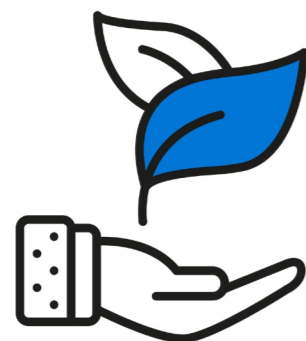
Illustrative example of capital structure for an affordable rented home, assuming 50% gearing.

Here we tackle each element of the capital structure (debt, equity, and subsidy) in turn to describe the current state of the affordable housing market, and its possible future evolution.

### Sector experiencing headwinds and limits to existing cross-subsidy models

Housing associations are facing a growing list of pressures including rising construction costs, property operational costs, the reduction in Government subsidy, and the need to forward purchase land to maintain scale and momentum. These all impact negatively on development viability and increase the amount of funding required from their balance sheet either from reserves, income from sales, or more borrowing.

Arguably the biggest headwinds facing the sector are from building safety works and decarbonisation programmes required to reach Net Zero Carbon. Much of this capital expenditure will have to be funded from housing associations own reserves and has very limited financial return in cashflow terms.



Many providers have pursued cross-subsidy models through which they undertake non-social housing activity in order to generate surpluses to use elsewhere. These models have their limitations and are coming under pressure partly because of the slow-down in prices and transactions and rising costs, but also as housing association capacity for risk is necessarily limited by regulation and lack of access to equity capital or more subsidy.

Additionally, some housing associations have seen their credit ratings worsen as a result of undertaking these more risky market-based activities when pursuing the cross-subsidy model. **This has a knock-on effect of increasing their relative cost of debt and reducing their borrowing capacity.**

This paper explores the scale of the supply challenge, and the funding structure of affordable housing supply. It then moves on to analyse the capacity of the housing association sector to build more homes, in context of the various headwinds and challenges faced. It finally considers the role that institutional investment can play in boosting financial capacity and making a step-change in affordable housing supply.



## Debt

**Availability of debt to housing associations remains as strong as ever.**

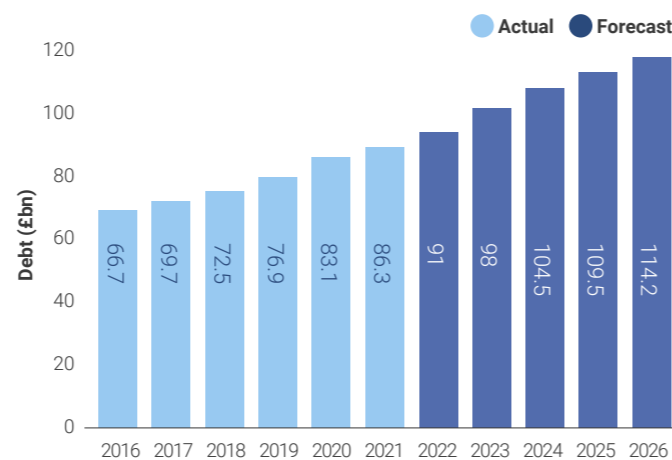
Housing associations have been significant recipients of debt funding for many years. Over £86bn of debt has been raised to date from a wide range of UK banks and building societies, international banks and Institutional investors.

One by-product of the 2008 financial crisis was that the debt market changed fundamentally. Bank debt had previously been issued in 30-year loans. Suddenly this contracted to 5 years and several lenders exited the market altogether. This triggered a pause in borrowing and changes in the profile of debt. It was a temporary pause and data from the Regulator of Social Housing's Sector Risk Profile shows that the sector's consolidated debt has increased rapidly over the last 5 years and is expected to reach £114bn in 2025/26.

**Whilst debt is readily available, housing associations are increasingly hitting gearing and interest coverage covenants where the constraints on equity and subsidy prevent them from taking on additional debt.**

There is a range in gearing headroom across the sector with some housing associations having greater capacity to take on additional debt than others.

### Sector Consolidated Debt



Global Accounts of private registered providers 2016-2021, RSH

## Equity

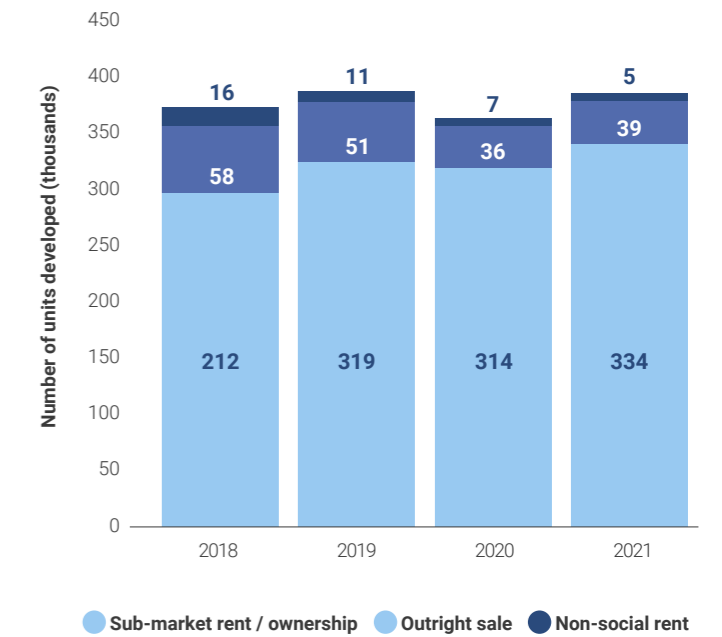
**Housing associations are fundamentally constrained due to their corporate structure.**

Housing associations are constrained in their ability to raise new equity capital by their status as not-for-profit entities which do not distribute any surpluses. **They lack access to one of the key tools that private entities have** – to supplement on-going operational returns with **the ability to raise new equity capital** alongside new debt capital. Instead they are restricted to building up these surpluses generated by any annual operational profits from net rental income and sales income that may be achieved and any valuation gains on their stock. Like all infrastructure asset classes, the impact is particularly stark for affordable housing given its capital intensity.

Some housing associations have sought to offset this lack of ability to raise equity by disposing of more marginal and costly to run stock – a process known as “stock rationalisation”. A similar effect has been seen at the corporate level, with associations looking for efficiency savings through mergers, such as Affinity Sutton and Circle into the sector's largest housing association, Clarion, in 2016. Whilst this is a route that can increase future surpluses and grow a balance of retained earnings through time, it is a far slower process than an equity raise and realising the efficiency savings promised by mergers can be difficult to achieve in practice.

Other housing associations have responded to current pressures and needs by diversifying into more market-based activity (homes for sale or market rent) as well as by taking activity the off-balance sheet and pursuing a cross-subsidy model. Data from the Global Accounts of Registered Providers suggests that the development of properties for sale is concentrated in a small number of providers, with c. 85% of turnover from outright sales reported by just 20 registered provider groups.

### Five-year Development Forecasts



Global Accounts of private registered providers, 2020-2021, RSH

The results have been mixed – whilst some additional short-term profits have been created, increasing development for sale activity has reduced lender appetite to invest, lowered ratings and thus decreased the capacity to borrow.

There are growing signs that **the cross-subsidy model has reached its limit**, a view also shared by the House of Commons Housing, Communities and Local Government Select Committee in its paper into building more affordable housing. This is backed up by the trend in development forecasts, with the sector reporting 39,000 outright sale homes in the 5-year pipeline from 2021. This reflects the continuation of a trend away from outright sales when compared to previous forecasts.



# Subsidy

## Beyond debt and equity - the distinct and crucial third leg of sub-market economics

Subsidy provision remains at near historic lows, however, there has been a notable increase in subsidy levels in recent months with the new Affordable Homes Programme, alongside developments such as Strategic Partnerships to make it easier for providers to access such funding.

It is important to remember that in the mid-1980s development was entirely funded by central Government and Local authorities. However, over time and notably after 1988 self-financing (from revenues) and external private financing through bank and building society debt became increasingly important. The chart below shows the rapid fall in the proportion of public funding:

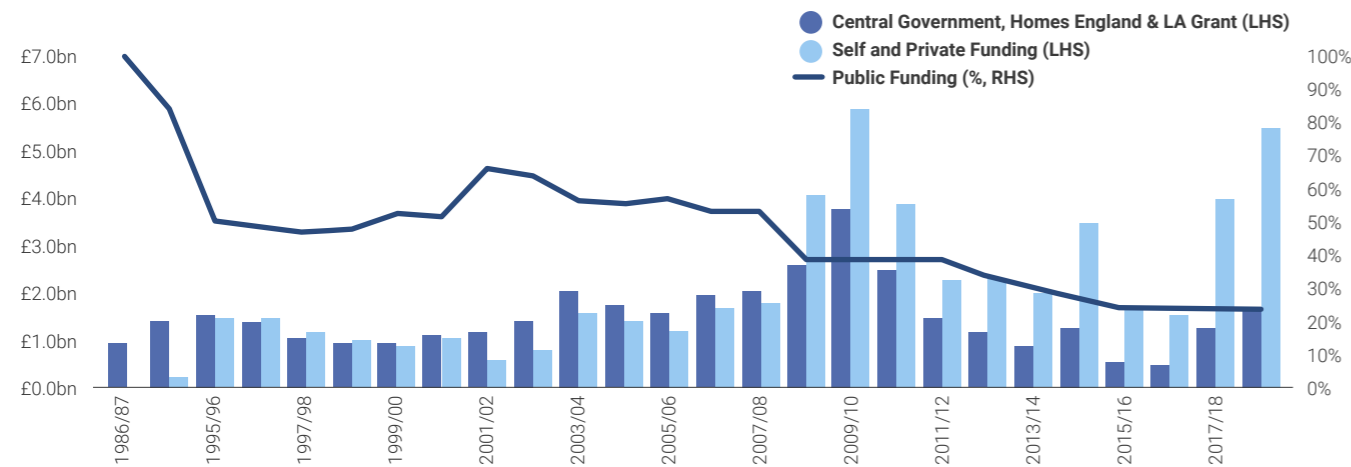
There is another dynamic at play alongside a decrease in overall subsidy availability; a shift in housing policy away from supply-based subsidy to demand-based subsidy. In 1975/76, 82% of subsidy (in £ value terms) was delivered via supply-based funding. By 2015/16 this was down to 4.3% with a large new reliance upon demand side subsidy – mainly housing benefit.

However, since 2010 we have also seen an erosion in housing benefit in terms of who is eligible, how it is uprated and what is covered. With these reductions and the rollout of Universal Credit, of which housing benefit is now a part, the capacity to pay rents – whether social, affordable or private has become less certain.

Network Homes paper (2019) compares the grant funded programme in 2008/11 with that now. It suggests that associations are receiving a third of the grant they used to receive and that in % terms grant had fallen from 51% of the cost of a home to 12%. Network had more than doubled the contributions (2.5 times) it was making via reserves and sales.

A paper by the National Housing Federation with the GLA (2019) estimated that production of the 145,000 affordable homes needed per annum would require grant in the order of £15bn per annum for ten years from 2021. In comparison, the next iteration of the Affordable Housing Programme will offer £11.5bn of grant over the 5 years from 2021-26 – just £2.3bn per annum.

### Housing Associations' Gross Investment Expenditure, in England



UK Housing Review, CIH, 2021

Lack of subsidy has significant impacts – felt most keenly in the limited provision of new core social rented housing, which requires the greatest subsidy. It also means that housing associations themselves have often had to use up their highly constrained equity base to ‘top-up’ the subsidy provided by the state. Of course, every time this happens, it reduces their equity capacity to build further new homes themselves.

Relying on a demand-side subsidy such as Housing benefit means that only those households in a priority need will be able to secure an affordable home, the remainder of eligible households are required to rent from the unregulated private rented sector with over 40% of private renters now utilising housing benefit to top up income to cover housing costs.



## Key questions

There are three factors required for affordable housing provision. Of the three, one is readily available (debt), but the other two are constrained by the dominant model of affordable housing provision via not-for-profit Housing associations (own equity) or as a result of Government housing policy (subsidy).

This paper assesses the funding of affordable housing delivery in the context of these three factors and will explore the changes required to bridge across to the target of 145,000 additional affordable homes needed per annum.

The key questions, which are explored in the following chapters of this paper, are therefore:

- 1 Given their inability to raise new equity and the wider pressures on the sector, how far can traditional non-profit housing associations increase their production of new affordable stock?
- 2 If a shortfall exists, how much subsidy does Government need to provide in order to meet the long-term affordable housing requirements?
- 3 Is there a role for institutional, long-term equity investors to plug the funding ‘gap’ and help meet the affordable housing supply shortfall?
- 4 If long-term institutional capital is willing to be deployed at scale into the affordable housing sector, what is the optimum position for housing associations to take in order to meet their core objectives?

# Sector capacity – in theory

Extrapolating from the consolidated sector accounts to identify the funding gap.

## Modelling – an outline

The model takes the 2020/21 Registered Social Housing Global Accounts (consolidated accounts of 1,000+ unit not-for-profit Housing associations) and projects forward the consolidated financial position over 15 years (up to March 2037) under different development programme assumptions, based on national targets and funding mix scenarios.

It assesses the capacity of the not-for-profit housing association sector to deliver the development programme based on its forecast financial capacity (as measured through gearing, interest cover and asset cover covenants and internal policy limits) and assesses the impact of any funding gap caused by capacity constraints on the ability to deliver the affordable housing target.

The modelling produces financial forecasts by combining baseline financial data with development scenarios to produce annual balance sheet and cashflow estimates.

It contains assumptions about indexation, the development programme, operating arrangements, and financing. These are based on published sources, industry standards or professional judgements.

In particular, the assumptions have been benchmarked against those used in the 2019 National Housing Federation and GLA modelling paper. In the base modelling, we initially assume a move towards a tenure split in line with the National Housing Federation proposed requirement – 59% social rent, 18% affordable rent and 23% shared ownership.

## Subsidy assumptions

The modelling assumes that capital grant levels are set to match the subsidy required per home. The model does not cap the overall provision of capital grant, and assumes that the grant available per home, by tenure is constant in real terms. This means that the total capital grant available to the sector in this model scales with the total number of homes created, even though the amount of grant per home is unchanged. The rates are set at £175k for a social rent home, £116k for an affordable rent home and £40k per shared ownership home.

The average market value of a new build affordable home is assumed to be £360k – this is significantly higher than the national average house price, reflecting the significantly higher weighting towards the South East of England of current affordable housing output. Subsidy requirement as a % of open market values therefore equate to 48% (social rent), 32% (affordable rent) and 11% (shared ownership).

## S106 assumptions

The model assumes that the volume of affordable housing delivered via housebuilder S106 obligations remains constant at 2020-21 levels, though the number of social/affordable rented and shared ownership homes produced per annum is likely to be lower due to the introduction of the new First Homes tenure. Increases (and decreases) in overall affordable housing supply in the model arise from changes in delivery in grant / Registered Provider funded delivery.

The chart right shows the components of affordable housing supply in 2020-21 for reference.

## 2020/21 Affordable Housing Completions

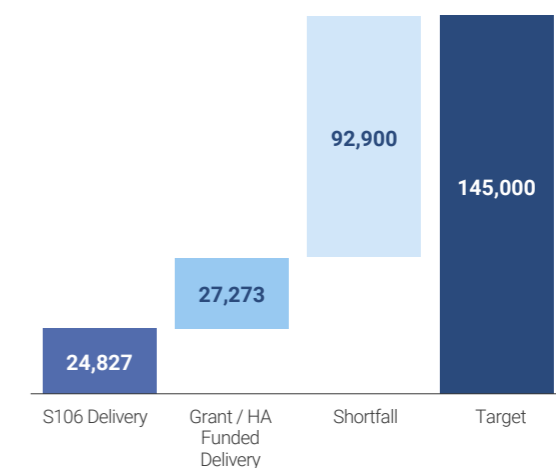


Table 1000, DLUHC, 2021

## Key assumptions

The table below summarises the key assumptions in our modelling:

<b>Tenure mix</b>	59% social rent, 18% affordable rent, 37% shared ownership, as per National Housing Federation recommendation.
<b>Grant amount / unit</b>	£175k for social rent, £116k for affordable rent and £40k for shared ownership for non-S106 units. Nil assumed for units delivered through S106 obligations.
<b>Open market value</b>	£360k per unit – average value of new-build home in England, weighted by sector's current geographic concentration
<b>Shared ownership</b>	35% First Tranche Sale, staircasing at 2% of property cost per annum
<b>S106 completions</b>	Held constant in line with 2020/21 completions at 24,827 units per
<b>Debt</b>	Starting cost of debt at 4.9% as per global accounts, 5% of outstanding debt refinanced per annum Cost of new debt assumed to be 4.5% to 2024, 5.0% to 2027, and 5.5% thereafter.
<b>Indexation</b>	CPI at 2% per annum RPI, Build Costs and HPI at 3% per annum All gross rents are assumed to index at CPI+1%



### Model outputs – key covenants tested

Our modelling tests three financial ratios: gearing, interest cover and asset cover. These ratios are typically the focus of debt covenants, and therefore the main financial tests of borrowing capacity and performance.

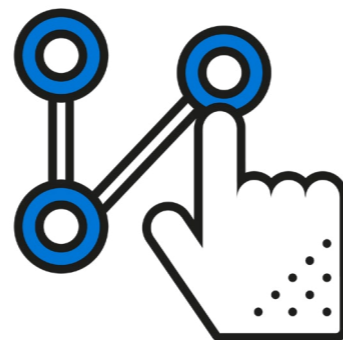
Whilst covenants represent the absolute limit before a breach of debt terms, Registered Providers will also set internal policy limits to provide some financial headroom for business resilience. The table below describes the ratios tested, as well as indicative covenant levels and typical internal policy limits:

Financial ratio	Definition	Covenant level	Internal policy limit
<b>Gearing</b>	Ratio of net funds borrowed to the gross property value (on a historic cost basis). The overall gearing ratio in March 2021 was estimated to be 46.8%.	65%	55%
<b>Interest cover</b>	Ratio of earnings before interest, tax, depreciation, and amortisation adjusted for major repairs (EBITDA MRI) to interest expenses. This is a measure of the business' ability to meet its interest payments with operating surpluses it generates. The March 2021 ratio was estimated to be 151%.	110%	130%
<b>Asset cover</b>	Measure of the business' ability to repay its debts after all liabilities have been satisfied by selling its assets. The overall asset cover ratio in March 2021 was estimated to be 128%.	110%	120%

### Note on capital constraints

The model assumes the construction of new affordable homes is funded entirely through new grant & debt funding in order to estimate the capacity of the not-for-profit housing association sector.

This analysis deliberately excludes the homes that could be delivered by institutional equity investment via For-Profit Registered Providers, which has already started to increase sector development forecasts as the first For-Profit Registered Providers have started to acquire units (albeit a relatively small portion of the consolidated total across all Registered Providers).



### Theoretical capacity of current sector

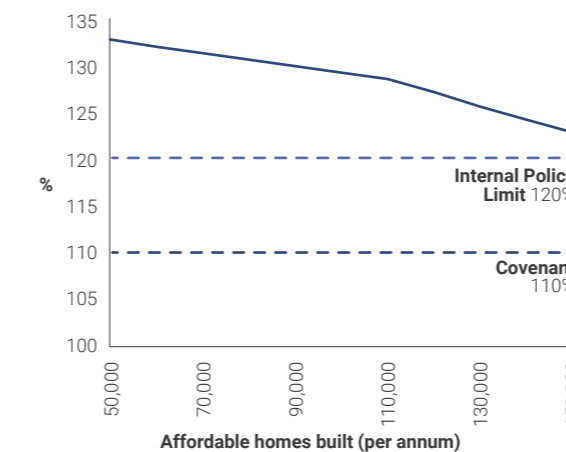
The charts on the next page show the impact to the three financial covenants of increasing the number of affordable homes completed per annum; assuming that the grant available per each additional home is held constant in real terms. **The sector is operating with headroom on both gearing and asset cover; however, interest cover is already a significant constraint.**

Whilst there is headroom to interest coverage covenants, there is very little room for expansion before hitting the internal policy limits. **Our modelling estimates that the sector can deliver 77,000 homes per annum within these constraints.**

### Key metrics

#### Asset Cover

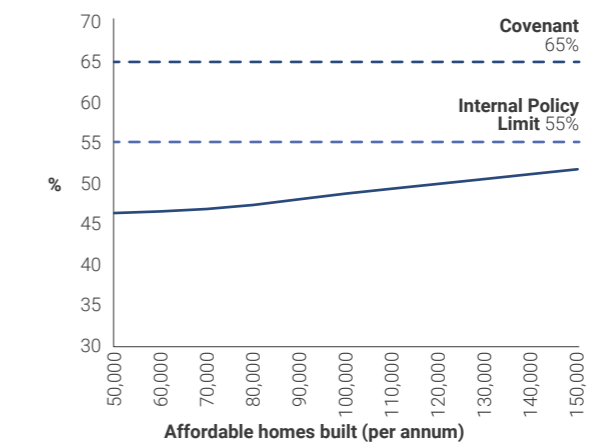
Ratio of the gross value of the business' assets to net debt.



Legal & General Capital, 2022

#### Gearing

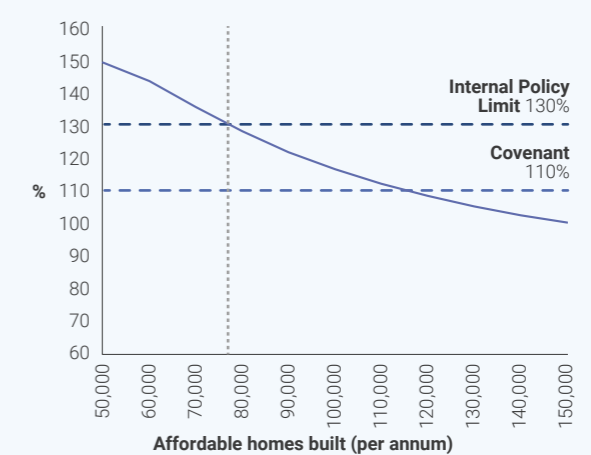
Ratio of net debt to the gross property value (on a historic cost basis)



Legal & General Capital, 2022

#### Interest Cover

Ratio of EBITDA-MRI (surpluses generated) to interest payable. Of the three metrics, this is the most significant rate-limiting constraint on supply with internal policy limits expected to be breached at just **77,000 homes** delivered per annum.



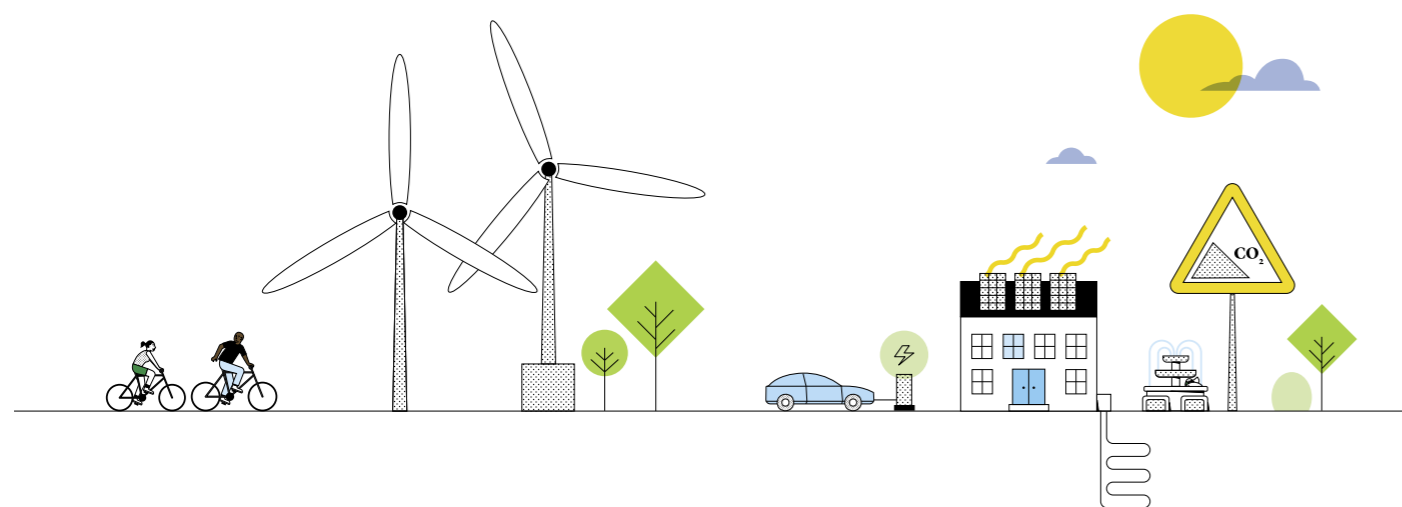
Legal & General Capital, 2022

# Projected sector capacity

The sector faces further additional and powerful headwinds that will be detrimental to affordable housing supply.

The analysis above highlights that the theoretical maximum capacity of not-for-profit housing association delivery, assuming a significant social rent programme with an increase in overall capital grant provision, is around 77,000 a year in the long-run. However, even in (a) 1990 – 2010 when Government was providing capital grant levels closer to these levels and (b) the years since 2010 when the subsidy requirement has been lower because of the push away from social rents to affordable / shared ownership tenures, average output from the sector has rarely been above 50,000 a year.

A wide range of operational, strategic, and financial factors sit behind this reality. As some are hard to quantify at a national level, they are shown here at a thematic level to create transparency around the level of the unique and multiple pressures that Housing associations face which in turn have a deep impact on their ability to develop more homes.



## Sector specific headwinds

We have avoided issues that are common to all housing developers – land availability, planning limitations etc. Rather what we set out below highlights some of the unique issues facing housing associations.

### 1. Fire safety repairs

There is an urgent need for capital expenditure on building safety following the Grenfell tragedy to remediate combustible cladding from high-rise blocks owned by the sector and other fire safety repairs. A survey carried out by the National Housing Federation in October 2021 found that 61 housing associations have found dangerous materials on their buildings and are having to retreat from building new affordable homes to focus spending on remediation works. It is estimated that this will result in 12,900 fewer affordable homes being built over the next 5 years; **2,600 less per annum**

The G15 group of the largest Housing associations in the country estimated in September 2019 that would be a cost of £6.9bn to make their buildings fire safe. G15 members make up c 32% of housing properties across the country (on a cost basis) and have been the most impacted due to a larger number of high-rises than the average housing association.

The National Housing Federation has estimated the impact of fire safety repairs for the sector as a whole would equate to a **non-recoverable funding cost of over £10bn**.

### 2. Retrofitting existing stock for decarbonisation

Whilst fire safety work may take place in much shorter order, the more significant pressure on the sector's financial capacity is arguably decarbonisation. The Government has said all affordable housing should be upgraded to a minimum Energy Performance Certificate level of band C by 2030, requiring 44% of the total affordable housing portfolio to be improved over the next ten years.

Further to this Net Zero carbon emissions on all homes must be achieved by 2050. A 2020 survey by Inside Housing estimated the total cost of retrofitting the c. 5m affordable homes owned by Registered Providers and Local authorities will be £104bn.

Savills have recently conducted further analysis on the 2.7m homes held by Registered Providers alone. There will naturally be some overlap between the required decarbonisation programme and planned capital expenditure, for example installing a new air source heat pump in the decarbonisation programme can replace planned expenditure to replace a gas boiler.

The Savills analysis accounts for this effect and has quantified an **additional long-term capital requirement of £50bn**, or £17,900 per unit for decarbonisation. Furthermore, this capital requirement is highly front-loaded with £20bn due before 2030.

Measuring the impact of this capital cost in housing supply, we estimate that this result in c. 8,000 fewer homes being delivered per annum for the next 30 years to 2050 -220,000 fewer homes in total.



### 3. Organisation-specific finances

£86bn of debt has been borrowed across the housing association sector as of March 2021. The aggregation analysis carried out in the previous section paints only the consolidated picture for the sector as a whole. On an individual basis, housing associations face a plethora of financial limitations specific to each organisation which mean actual borrowing capacity for the sector is lower than modelled in the previous section.

These financial limitations may also change as the sector's development activity increases, and lenders adjust their approach to reflect a shift up the risk curve:

#### 3.1. Specific covenant terms

Definitions for loan covenants vary across the sector and can be very nuanced. Many organisations have covenants that are set at tighter level or are more onerous than analysed here. For instance, some include adding back of major repairs, mark-to-market movements in financial derivatives or adding back possible impairments in their interest cover covenants.

#### 3.2. Stress testing requirements

Housing associations financial planning will typically include some conservatism in addition to Internal Policy Limits to allow business plans to survive stress scenarios. This affects interest cover in particular which is arguably at the greatest risk of an inadvertent breach if operating close to limits.

#### 3.3. Equity cure

Unlike most private or institutional companies, 'equity cures' are not systematically available. For instance, many large companies can, if they so wish, avoid covenant breaches by rebalancing the equity / debt mix in a given company or subsidiary through further capital injections. As housing associations do not have this ability, they must maintain some additional headroom against covenants.

#### 3.4. Covenant focus changes through time

Over the last decade, we have seen a significant shift in the nature of covenants utilised by Housing associations. Generally, the shift has been from a historic asset specific level covenants to corporate ones. In line with significant accounting changes c. 5 years ago, many gearing covenants were moved from a valuation basis to either an actual cost or a deemed cost basis. It is possible, particularly in a higher development scenario, that lenders would wish to (rationally) wish to protect their positions by tightening covenants to more appropriately reflect the economic realities of the sector at the time.

#### 3.5. Cost of financing rises

Furthermore, if Housing associations try to materially increase their development output, credit quality of Housing associations generally worsen due to lower covenant headroom which has a knock-on effect of increasing financing costs.

### 4. Cross-subsidy model

Partly in lieu of the lack of subsidy provided by Government over the last decade and partly due to a lack of general equity capacity, many large Housing associations have turned to the development for sale market to seek to generate further profits to re-invest in new affordable housing developments.

Whilst this saw some success, it has a negative impact on credit ratings with Moody's specifically citing the risk of lower market sales receipts as a key factor that could lead to a negative outlook for Housing associations in their February 2021 sector outlook. Some associations such as Swan (2020) have already had their credit ratings downgraded given the higher risk profile associated with market sales.

The impact of a lower credit rating per notch typically varies between 10 and 25bps in terms of the cost of new debt. This leads to a knock-on effect where the profits generated

through market sales are offset by increased financing costs, especially when valued over the lifetime of new debt issuance.

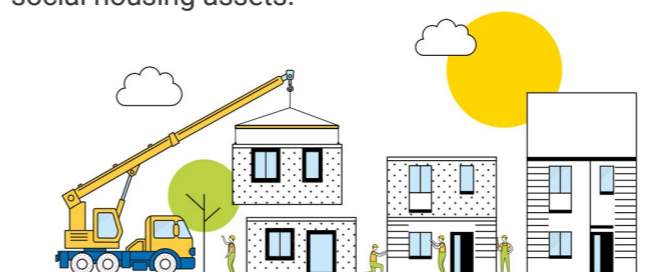
### 5. Development expertise

Carrying out development at scale requires significant investment into development, operations, and sales teams. This is particularly true for land-led schemes (as opposed to section 106) where deeper land, design, planning, project management, financial analysis and placemaking skills are further required. Whilst some of the largest housing associations have built a scalable function, many of the mid-sized or smaller Housing associations may struggle to build up and support such a team.

### 6. Risk appetite – a unique position

Housing associations operate in a relatively unique position – being in a very capital-intensive industry within the 3rd sector. They are neither accountable to shareholders nor to Government directly but remain under pressure to maintain high viability standards by their Regulator whilst being under pressure from Government to increase output.

Whilst this position allows Boards to decide the future of their own organisations without the ability for external influencers to directly impose new requirements, it can lead to a highly varied position across the sector in terms of the balance between risk aversion and determination to develop at higher levels. balancing exposing businesses to increased commercial risk whilst preserving the protection of the social housing assets.



## Key question



**1** Given their inability to raise new equity and the wider pressures on the sector, how far can traditional non-profit housing associations increase their production of new affordable stock?

Our analysis shows a maximum long-run capacity of not-for-profit Housing associations to deliver up to **77,000 homes per annum in theory** compared to c 50,000 homes currently being delivered annually. The sector as whole faces severe strategic and financial obstacles such as building safety and decarbonisation. We estimate that these challenges will consume most of the current headroom and the maximum capacity of the not-for-profit sector is **65,000 homes per annum in reality** – well short of the 145,000 homes that most sector commentators believe is required.

### Unlocking additional capacity

The sector is already close to debt limits, and with the substantial headwinds ahead unlikely to be able to increase supply.

Only new equity capital entering the sector can overcome these financial limitations – equity can decrease gearing and in turn boost interest cover and asset cover to a sustainable level that allows development to be increased.

The lack of equity capital in the sector (and the inability for housing associations to directly raise the capital) means that Housing associations alone cannot increase output to the level required. The following sections discuss potential models to harness institutional investment to unlock additional capacity and drive up affordable housing supply.

# Meeting the subsidy funding gap

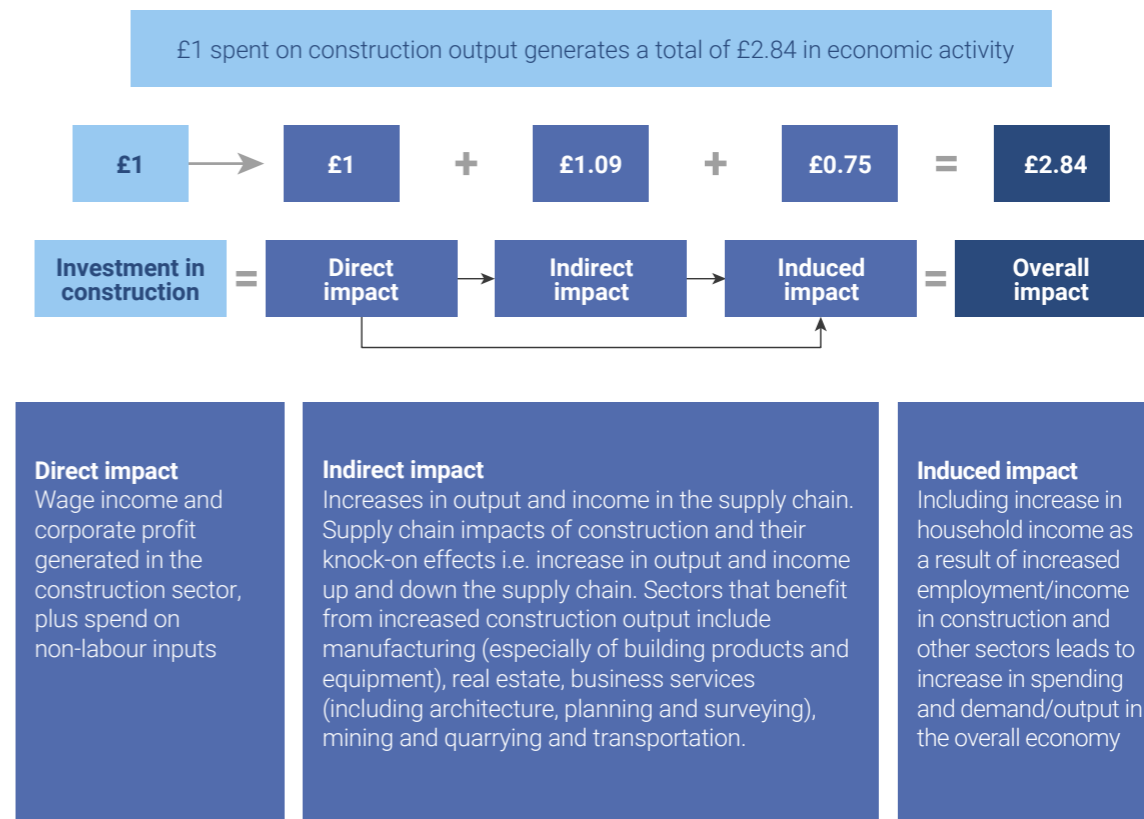
The sector needs to make the best use of available subsidy, and to channel new subsidy into new homes.

## Public return on subsidy

There is a strong public investment case for Government subsidy programmes, in addition to the immediate requirement to deliver on housing need. This is both through the multiplier effect of increased economic activity, and through the impact on the public purse through reducing the social externalities of poor housing. Lack of good quality housing has been linked to increased levels of crime and offending, lower educational attainment, and worse health outcomes.



## The economic impact of investment in housing



Capital Economics, 2019

A paper by Capital Economics (2019) estimates that for every £1 spent on construction output, £2.84 of additional GDP is created and an additional 54p benefit is generated for the Exchequer. This is due to the additional wage income, corporate revenue and new jobs created through the supply chain.

**All of this reinforces the point that this is not a zero-sum game, the return to the public purse exceeds the cost incurred to originally provide the subsidy.**

There is an even bigger impact if that same £1 was to be used to develop new affordable housing, rather than construction more generally due to savings on other public expenditure. The same paper goes on to note that the Government pays £2,500 more in housing benefit for a household renting from a private landlord than in social housing. Taking both the construction multiplier and the savings on housing benefit into account, it notes an average benefit of £18,060 to the state for each new affordable rented home constructed.

It is possible to address the societal need for new affordable homes, whilst generating an overall return for the state through reducing expenditure on housing benefit and spurring on economic activity and job creation in the economy.



## Modelling subsidy requirements

If we assume the same requirements of subsidy per unit as in our sector modelling (£175k per social rented, £116k per affordable rented and £40k per shared ownership), the total subsidy consumed by the sector for the 52,000 homes completed in 2019 was £5.1bn. This was funded through a mixture of housebuilder S106 obligations, capital grant and own investment.

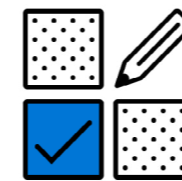
It is an unavoidable fact that increasing the supply of affordable housing from the current provision to the 145,000 target will require an increase in the overall subsidy provided (all else being equal). If we assume a constant tenure mix as per the 2020/21 completions, **increasing supply to 145,000 homes would result in an additional £9.2bn of subsidy being required and consumed per annum**

The tenure mix also has an impact on the amount of subsidy consumed, delivering a higher percentage of social rent will reduce the valuation of the completed homes – increasing the gap to market value, and the subsidy requirement.

Opinions vary on the exact tenure mix we need to deliver to meet the nation's housing need, however research from the National Housing Federation proposes that the tenure mix needs to be rebalanced to deliver 59% for social rent. Just applying this change to the 52,000 homes built in 2020/21 would result in an additional £1.8bn of subsidy being consumed and applying it to the full 145,000 homes increases the additional subsidy required from **£9.2bn to £14.2bn**.

## Means of subsidy provision

In the UK, subsidy is provided to support the provision of new affordable housing in a number of direct and indirect ways.



### 1. Via S106 planning obligations.

Planning obligations under Section 106 of the Town and Country Planning Act 1990 are legal obligations entered into to mitigate the impacts of a development proposal. They run with the land and are legally binding and enforceable. The most common uses of planning obligations are to secure affordable housing, and to specify the type and timing of this housing. Section 106 contribution sizes are typically a negotiation between the developer and the local authority planning offices as part of the request to gain planning permission.

This has grown rapidly over the past 10 years with c. 25,000 homes delivered via S106 in 2020/21, representing 48% of all affordable housing delivery.

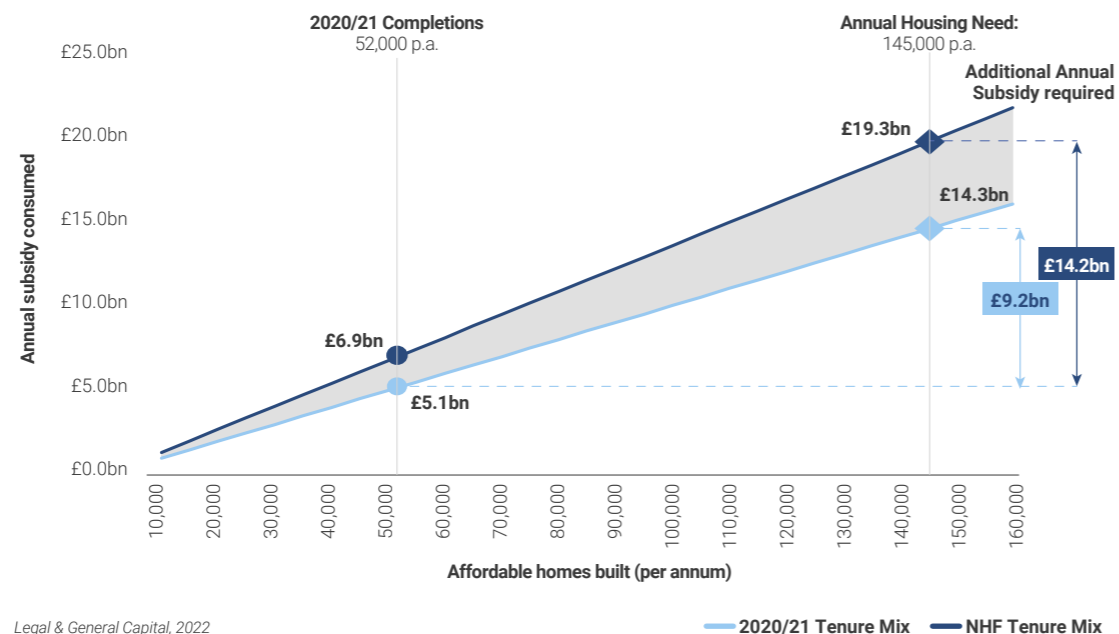
In S106s, the subsidy element is generated by the significant decrease in the value of the land that is created from the requirement for the land to be utilised for affordable housing. The specific tenure required under the S106 (social rent,

affordable rent, shared ownership etc), typically dictates how much of a subsidy will be created given each tenure type has a different economic value.

Whilst in theory Local authorities could increase the proportion of affordable housing provided under the S106 to grant planning permission, planning officers need to ensure that the level is not increased so far as to make the underlying development unviable – at which point no housing (private or affordable) will go ahead.

The Government has recently introduced a new tenure of affordable housing: First Homes. These are required to be sold at a minimum discount of 30% to open market value to first time buyers, with the discount applying in perpetuity. As a relatively new tenure, the take-up is still to be proven however it is eligible to be included in S106 obligations and will likely result in fewer social rent/affordable rent/ shared ownership units being delivered via S106.

### Estimated Subsidy Requirements





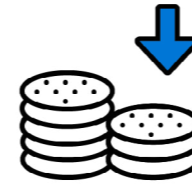
## 2. Direct capital grant.

This is arguably the most straight-forward means of channelling subsidy to the direct provision of new affordable homes. Investment in the sector has traditionally been dominated by grant funding from central Government and Local authorities, however as previously discussed this has changed considerably over the past 30 years. The 2021 Housing Review estimates that grant funding is expected to reach just 9% of development costs for the sector.

This long-term trend is slowly reversing with an increase in grant availability through the latest allocations programme. The Government has recently announced a total of £7.39bn of grant funding from April 2021 to March 2026 through Homes England to deliver up to 130,000 affordable homes outside of London. In addition, the Greater London Authority has secured £4bn for up to 82,000 homes over the same time period – with more than half the programme expected to be at social rents – the tenure that requires the greatest level of subsidy. Combined, this equates to £11.4bn for 212,000 homes (around £1.8bn a year) at an average grant rate of £54,000.

Our analysis assumes £175k of grant is required for a social rented unit, £116k for an affordable rented unit and £40k for a shared ownership unit. Therefore, it is very hard to produce tenures other than shared ownership – particularly in London and surrounding areas – without significant additional subsidy from other areas described below.

Additionally, recent policy announcements around shared ownership – including the requirement of the Registered Provider to cover the cost of repairs for the first 10 years, are expected to increase the subsidy requirement by up to £10,000 per home. In turn, this reduces even further the number of new affordable homes that can be delivered without incurring an economic loss compared to market returns.



## 3. Tax reliefs

Housing associations benefit from charitable status, and pay neither corporation tax or stamp duty land tax (SDLT) on both S106 and grant supported schemes as a result:

### 3.1 Corporation tax

Annual surpluses of not-for-profit housing associations in 2020/21 stood at £2.9bn. Applying a corporation tax rate of 20%, this totals to an existing tax benefit of c.£600m.

### 3.2 Stamp duty land tax (SDLT)

The housing association sector spent around £8bn in new supply in 2020/21. Assuming an average land value of 30% of total scheme cost for non-S106 schemes and SDLT of 5%, the annual tax saving was c. £70m to the sector. Again, looking at it from a new build perspective, this equates to an economic subsidy of around £5k per unit built.

Whilst For-Profit Registered Providers can receive SDLT exceptions on grant-supported schemes, they cannot receive the same benefit as not-for profit housing associations on Section 106s. Although it will vary by structure, most will also pay full corporation tax on their profits each year.

**There is a policy question as to whether some of these tax reliefs could be extended to the institutional sector, as this burden currently leads to an increase in the requirements for capital grant or other forms of subsidy.**

It is worth drawing international comparisons, as other tax benefits programmes are often utilised in different countries. For example, the USA uses a system of tax credits for investors in return for the provision of additional affordable housing.







#### 4. Debt guarantees

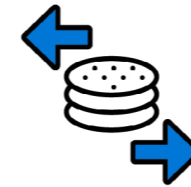
A new £3bn affordable housing debt guarantee programme was announced by the Housing Minister in October 2020 and is available to both not-for-profit housing associations and For-Profit Registered Providers. The subsidy is created by reducing the long-term cost of debt for a Registered Provider from their normal borrowing cost level to a level closer to Government borrowing costs.

Assuming the £3bn is fully allocated and assuming an average 1.00% saving in interest costs a year, this would equate to an ongoing saving of c. £30m a year to the sector and £600m over a typical 20-year debt term.

At an assumed 50% gearing level and average cost per home of £350k, this would equate an economic subsidy of £350k x 50% x 1% x 20 years = £35k per unit. Whilst this may only provide enough subsidy for some shared ownership homes if considered in isolation, it could act in combination with other subsidy activities to increase viability for development of social and affordable rented homes also.

However, as the subsidy comes through gradually over the life of the debt, unlike subsidy created through capital grant or from S106 agreements, the upfront impact on housing association gearing ratios is still as large as traditional debt financing. It doesn't overcome the key covenant barrier to growth of their leverage ratios.

Gearing covenants are likely to be less of an issue for institutional investors, meaning that the realised economic benefit of debt guarantees is more direct and can spur on supply immediately.

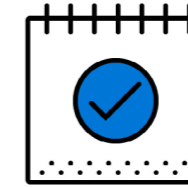


#### 5. Revenue subsidies

Housing benefit payments from Government now stand at over £23bn a year, and are provided to over 4m households, according to data from the OBR. This is not a subsidy to a Registered Provider or Local Authority – it helps to cover some or all of the subsidised rent that is charged to the tenant, rather than to fill the gap between the subsidised rents and open market rents that are not charged. It is a demand-side subsidy rather than supply side.

Housing benefit, while gradually being consumed into the wider Universal Credit, provides a mechanism for providing access to subsidised housing. Indeed, it already takes place on mass within the private rented sector, generally supporting households in need who have not been allocated specific Registered Provider or Local Authority properties through the support in paying some or all of the rent due.

There have been long debates across different industries around demand vs supply side economic models. This paper does not seek to enter this debate any further and instead has focussed on the financial limitations of the existing supply-side market participants in the affordable housing sector.



#### 6. Rent certainty

The current rent settlement with social housing rents increases at CPI +1% is only in place until 2025, with the future rents to be confirmed. The sector has recent experience on rent uncertainty, with the 1% real reductions from 2015-19. This led to housing association's having to remodel their business plans leading many to cut their overall development programmes.

Rent certainty is a key driver for affordable housing valuations. These assets are typically valued using a discounted cashflow methodology, which takes the present value of the future cashflows associated with a property to assign a valuation for the asset today.

**Cashflows that are more predictable and have less volatility have a stronger rating and are therefore more valuable. By providing greater certainty around future rent settlements, the Government would increase the valuation of affordable housing and reduce the amount of subsidy required to provide the homes.**



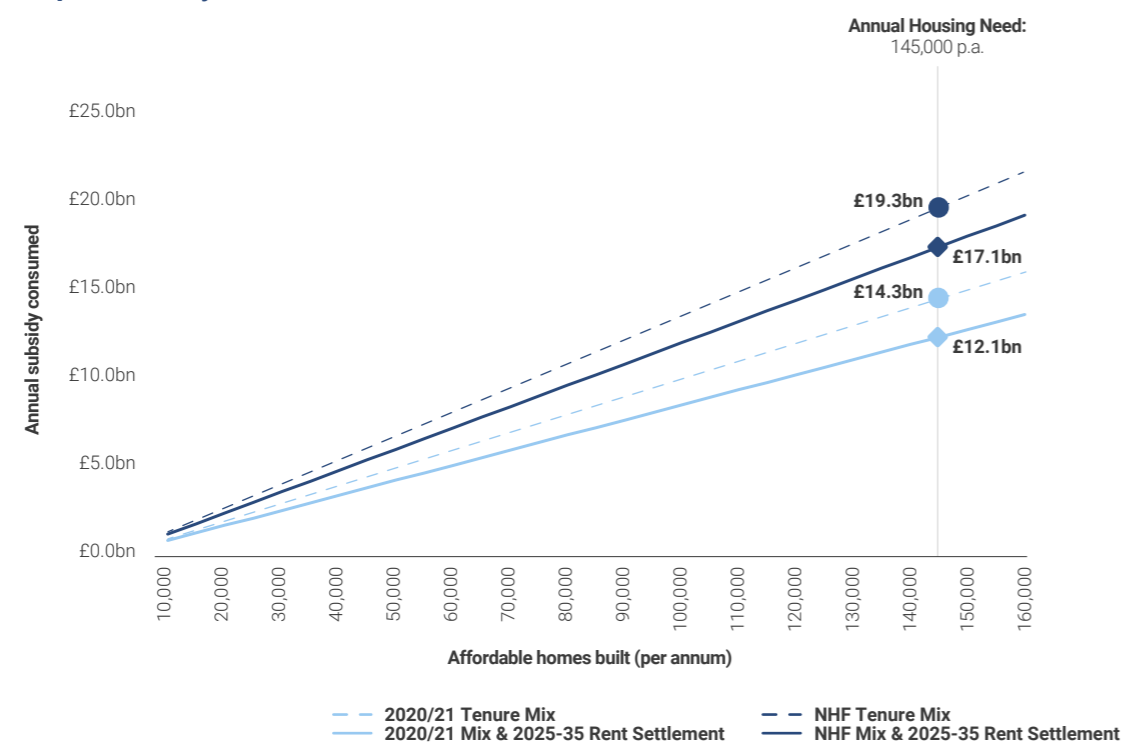


Looking at the sector's production as a whole, this would lead to a c. £2bn reduction in subsidy consumed to deliver the 145,000 per annum target at both the 2020/21 and National Housing Federation proposed tenure mixes

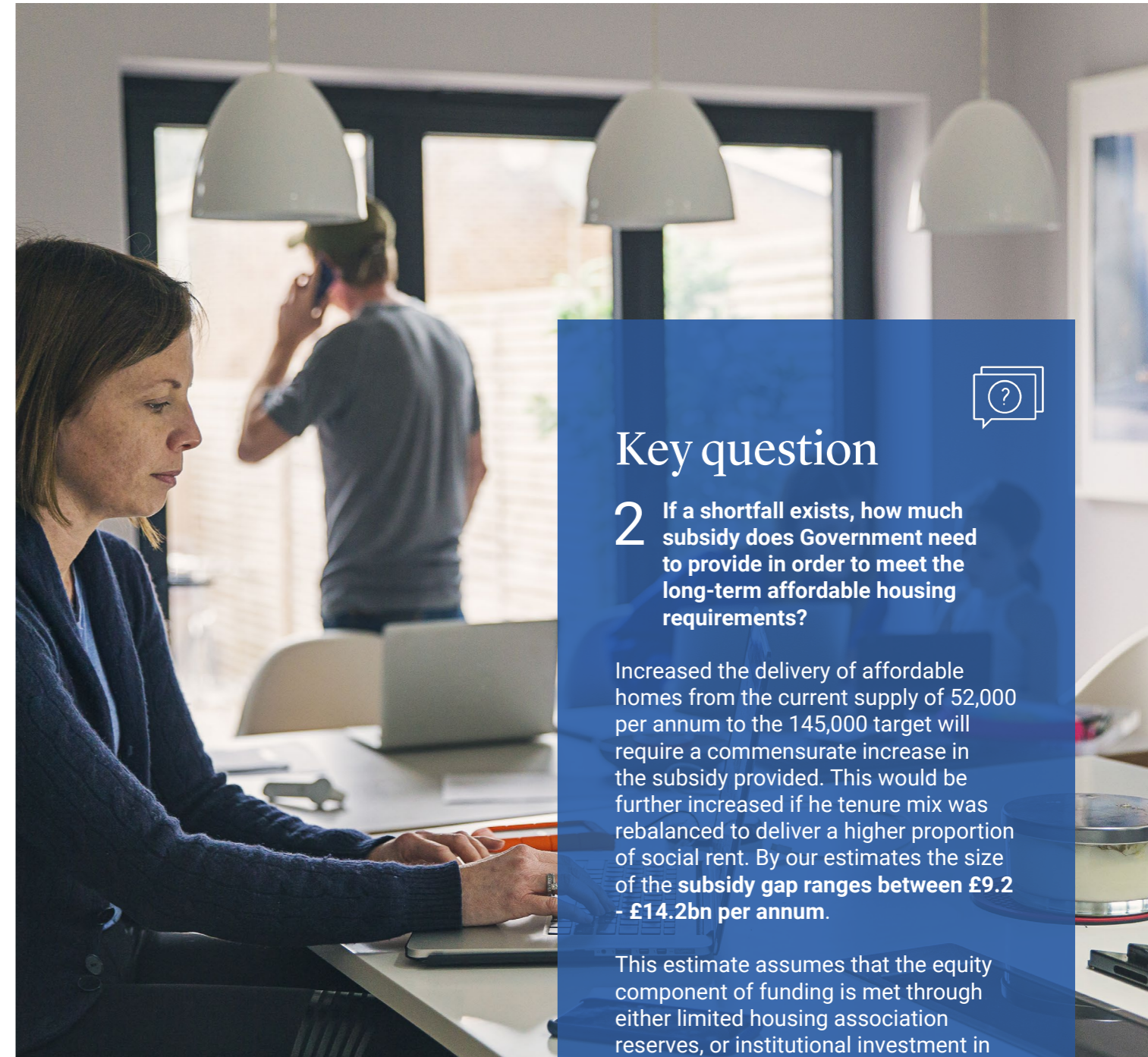
If the Government provides another 10 years of rent certainty with a settlement through to 2035, and we assume that this results in a 10% increase in affordable housing valuations this would equate to £16-22k reduction in subsidy requirement per unit.

Separately to the point on valuations above, rent certainty is an incredibly important factor for institutional investors who typically have long-dated obligations and liabilities to match against. By providing this certainty, Government can help drive funding efficiencies and attract the cheapest cost of capital to the sector, reducing the overall cost of provision.

### Impact of 10-year rent settlement



Legal & General Capital, 2022



## Key question

**2** If a shortfall exists, how much subsidy does Government need to provide in order to meet the long-term affordable housing requirements?

Increased the delivery of affordable homes from the current supply of 52,000 per annum to the 145,000 target will require a commensurate increase in the subsidy provided. This would be further increased if the tenure mix was rebalanced to deliver a higher proportion of social rent. By our estimates the size of the **subsidy gap ranges between £9.2 - £14.2bn per annum.**

This estimate assumes that the equity component of funding is met through either limited housing association reserves, or institutional investment in For-Profit Registered Providers. If this equity is not available, Government would need to provide additional subsidy to bridge the gap. Probably the single most effective action Government could take to reduce the subsidy gap is a new long-term rent settlement to 2035. **This rent certainty would boost affordable housing valuations and reduce the subsidy gap by c. £2bn.**



# Meeting the equity funding gap

Institutional investment can work alongside housing associations to unlock additional affordable housing supply.

For-Profit Registered Providers were first permitted as result of the Housing and Regeneration Act 2008, enacted by the Government following recommendation of the Cave review in order to “expand the availability of choice of provider at all levels in the provision of social housing”. This opened the door for institutional investors to push equity into the sector by being able to own affordable housing, whilst also being eligible to receive social housing grant.

## Small, but growing institutional investment market

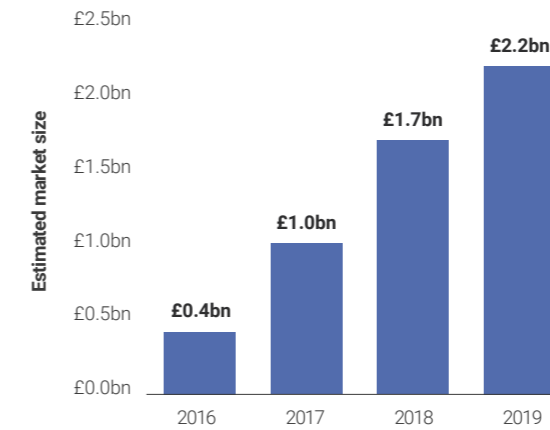
Traditionally equity investment in the housing market has been most common in the housebuilders sector. Over the past 20 years, we have seen the equity market widening to various kinds of operational real estate such as Student housing and Later living and, more recently, the Build to Rent market. This is a signal of the current strong investment appetite for residential housing and indeed in some instances this has displaced Government funding, for example, university provided accommodation being replaced by private housing providers.

Compared to these sectors, affordable housing is relatively new ground for private capital, albeit now growing rapidly. In 2015, the Investment Property Forum published a study on ‘Prospects for institutional investment in social housing’ which concluded that current investment was around £0.4bn. Fast forward to 2019, and responses to Big Society Capital’s market sizing study indicates investment into affordable housing had grown to £2.2bn – a 5.5x increase.

By 2020, the number of For-Profit Registered Providers had grown to 49 with over 9,000 homes under management and by 2021 the number was up to 63.

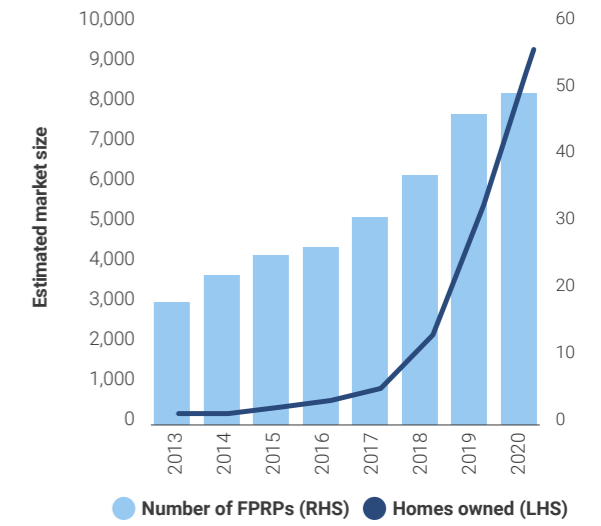
A recent paper by Savills estimates that For-Profit Registered Providers could account for delivery of 100,000 affordable homes per annum from 2026.

## Estimated market size for institutional equity investment in UK affordable housing



Big Society Capital, 2021

## Growth in FPRP stock



RSH, 2021

## Attractiveness for institutional investors

As an asset class, affordable housing has a number of attractive financial characteristics for institutional investors:

### Stable, long-term inflation-linked cashflows

The profile of the returns generated by these assets are well-suited to match against the similarly long dated and inflation-linked liabilities that pension plans and insurance companies typically face.

### Diversification

Investors are increasingly seeking exposure to real assets with low correlation to economic cycles, and affordable housing is almost the definition of a counter-cyclical investment. The majority of institutional investment in real estate is in commercial property, and this asset class provides investors with a new opportunity to balance concentration across their portfolio.

### Structural Supply/Demand imbalance

With the huge mismatch between social housing waiting lists and affordable housing supply, void levels are very low and there is a sizable gap for new supply to fill.

### Scalable opportunity

Investors need to be able to deploy at scale to invest efficiently, and many already have large real estate platforms and expertise to utilise.

The positioning of risk each equity investor is willing to take varies, with the return requirements sliding to match. Some are focussed on shorter term development risk (c. 3-5 years) looking at typical real estate private equity type returns, whilst others are only able to take stabilised assets, but are seeking a bond-like return for a long-term hold (c. 40-50 years).

Early investors focussed on partnering with existing housing associations on a lease-based model, however more recent investors are increasingly willing and able to own and manage affordable housing outright and directly lease to tenants through the establishment of For-Profit Registered Providers.



## Social Impact / ESG

In addition to the financial characteristics of the assets class identified above, there is **strong evidence that the provision of quality, affordable housing contributes to multiple positive outcomes for individuals and society as a whole.**

There is a growing awareness of social impact and ESG considerations amongst investors, who are keen to examine the credentials of their investments and are increasing allocations to assets that have high impact/ESG scores.

There has been considerable development in ESG reporting in the sector, led by The ESG Social Housing Working Group who released their sustainability reporting standard for social housing in November 2020. The group included housing associations (such as Clarion and Optivo) and investors (such as Insight, M&G, Legal & General and NatWest).

## Private capital funding models

There are currently 64 For-Profit Registered Providers registered with the Regulator of Social Housing with a range of ownership structures. Some have been set up by developers but there a considerable number of funder-entrants to the sector, from affordable housing REITs to institutional funders (such as Legal & General, M&G, Sage).

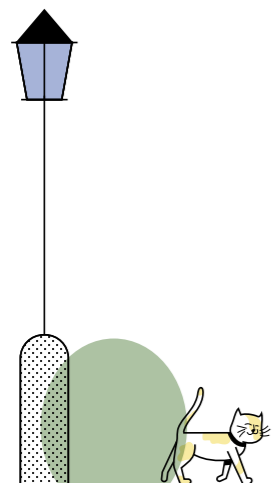
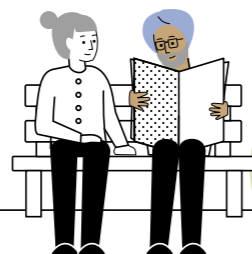
These institutional funders typically work in tandem with housing associations acting as management providers, such as the partnership between Sage and Places for People. These arrangements allow investors to benefit from the vast expertise already in the sector.

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**There are a wide range of investors with differing risk appetites, and a need to work together with housing associations to find a model that suits the needs and objectives of both organisations.**

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For example, a smaller housing association may seek to partner up with an investor with development experience who can help the housing association scale and provide resources to the partnership beyond purely financial ones.



## Key question

**3 Is there a role for institutional, long-term equity investors to plug the funding 'gap' and help meet the affordable housing supply shortfall?**

The advent of For-Profit Registered Providers has provided an opening for institutional investors to bring much-needed equity investment into the sector. The aims and objectives of the investors are closely aligned with the societal purpose new affordable housing provides, with investors benefitting from a long-term cashflow and households benefitting from security of tenure and high-quality affordable accommodation.





## Case study Legal & General Affordable Homes

Legal & General set up its wholly-owned For-Profit Registered Providers in 2018 to develop and acquire affordable housing for long-term ownership.

It has since grown its development pipeline to over 7,000 homes throughout the country to help meet the needs of local communities and to deploy institutional capital at scale.

The Registered Provider operates using a framework of 14 housing associations and management partners that manage Legal & General's properties, and recently began the process of acquiring shared ownership homes from these partners with a landmark 47-home deal with CHP Homes.

Legal & General Affordable Homes signed a joint venture agreement with Coastline Housing in 2019, which is expected to see Coastline deliver between 100 and 300 homes per year to be owned by Legal & General Affordable Homes and managed by Coastline.

Legal & General Affordable Homes was also named as a strategic partner for Homes England under the Affordable Homes Programme in 2021.



For-Profit Registered Providers present an opportunity for institutional investors to meet the equity funding gap, and can take on many forms:

### 1. Direct investment by institutionally owned For-Profit Registered Providers into new stock

For-Profit Registered Providers are broadly split into two classes: (i) those entering the S106 market only; and (ii) those with Direct Delivery capabilities. Most For-Profit Registered Providers fall into the former category, which requires a significant amount of resourcing to bid on and acquire homes at scale but is reliant on affordable housing secured via planning obligations.

A minority of For-Profit Registered Providers have the capability to pursue land-led schemes where deeper land, design, planning, project management, financial analysis and placemaking skills are further required.

Whilst some of the largest housing associations have built a scalable function, many of the mid-sized or smaller Housing associations may struggle to build up and support such a team. In this case, not only is the For-Profit Registered Providers bringing equity investment to the table; it is generating an additional supply of affordable housing to the sector.

## 2. Development Joint Ventures with housing associations

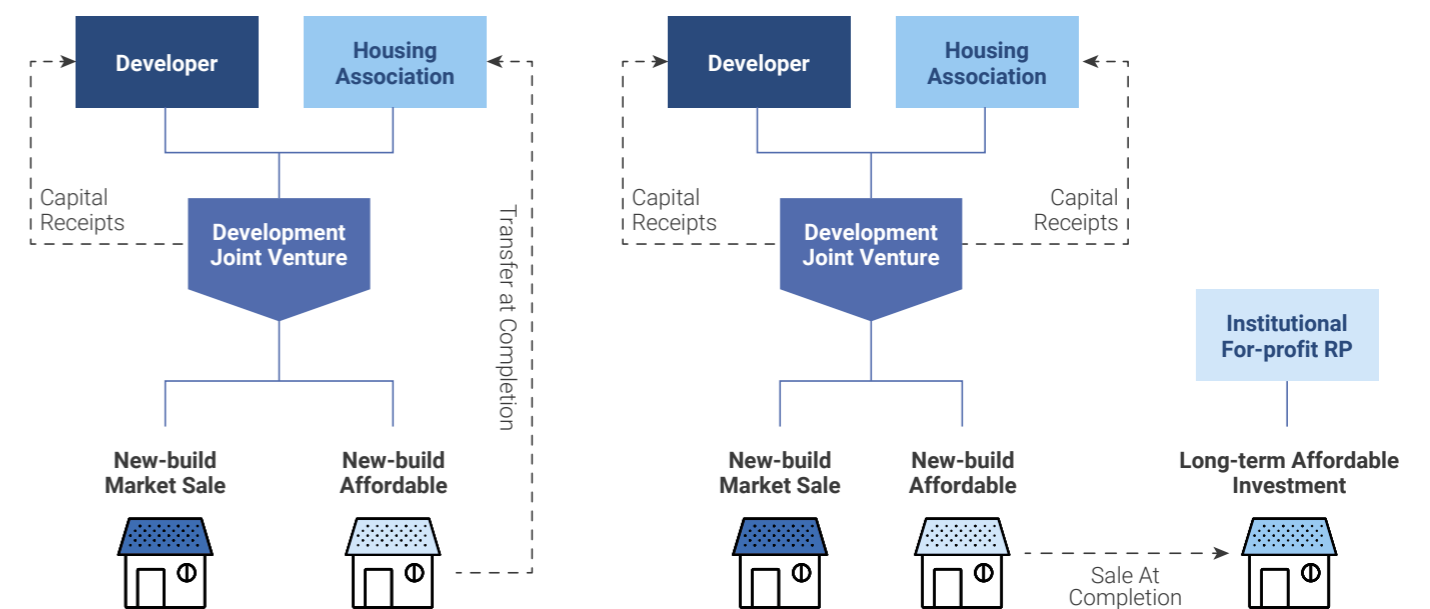
Institutional investors can enter the sector via Joint Ventures with housing associations. This is already being done but is generally limited to outright sale exposure or non-social housing assets. Setting up a For-Profit Registered Providers can allow this type of partnership to move back into affordable housing led development.

Most existing Joint Ventures are focused on market homes built for sale on the open market or affordable homes transferred to the housing association partner for long-term hold. However, it is this long-term hold that ties up housing association balance sheet capacity. A more efficient solution could be for the homes to be transferred to an institutionally owned For-Profit Registered Providers at the end of the development phase.

Few housing associations are currently participating in this type of Joint Ventures but many of the larger housing associations are currently exploring it with some notable transactions in 2021.

In November 2021, Optivo agreed to sell 420 affordable homes under construction to Sage, 155 of them for general needs rent and the remainder shared ownership. Optivo will oversee the remaining construction of the sites, and then manage them on behalf of Sage once completed. All £100m+ proceeds from the sale will be reinvested by Optivo into new affordable homes.

### Examples of development joint ventures



For illustrative purposes

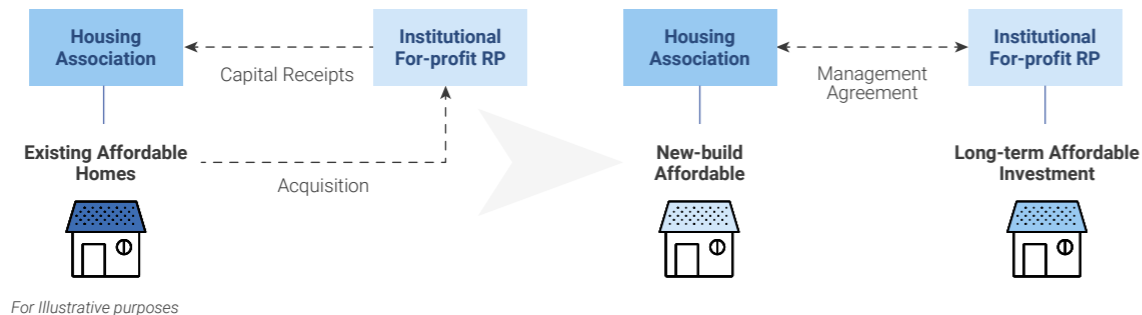
### 3. Existing Stock Acquisition Partnerships

There already exists a market for trade of existing stock, but this mainly occurs between housing associations and is quite often driven by a desire for stock rationalisation. Whilst this can bring operational efficiency for housing associations, **transfers within the sector do not alleviate the pressure on the sector's consolidated funding capacity.**

An alternative solution would be a partnership between an institutionally funded For-Profit Registered Providers and a housing association to purchase its existing stock. This would provide a significant and immediate capital injection into the sector through the sale proceeds received by the housing association, as shown in the diagram below.

It is likely that institutions will be attracted towards newer assets in the early years on their involvement. This would be an easier proposition to raise capital from underlying investors, however over time this kind of transaction could also be combined with asset regeneration programs.

#### The economic impact of investment in housing



The For-Profit Registered Providers would benefit from certainty of investment pipeline and would be able to offer a cheaper cost-of-capital as a result, whilst the housing association can use the sale proceeds to pursue new developments and activities to drive social impact.

There is also the potential for a Management Agreement between the For-Profit Registered Providers and the Housing association such that the For-Profit Registered Providers retains the day-to-day management of the homes post-transfer. This will preserve the total assets under management of the housing association, whilst bringing a potential revenue source.

This type of partnership between housing associations and investors is some way behind the development-led partnerships, but some large housing associations are actively considering this model. Places for People are already carrying this out via their PFP Capital subsidiary.

There are difficulties encountered with the difference in grant regimes between not-for-profits and For-Profit Registered Providers, who are required to pay an additional amount of grant back on future receipts. This means that a For-Profit Registered Providers would require a greater amount of grant for the same property than a not-for-profit. This friction could be relieved through a change to the grant conditions and which might in turn unlock stock acquisitions as a funding source for the sector.

## Key question

**4** If long-term institutional capital is willing to be deployed at scale into the affordable housing sector, what is the optimum position for housing associations to take in order to meet their core objectives?

Institutional investors come in a variety of shapes and sizes, with differing mandates and risk appetites. As shown in the diagram, there are already numerous examples of investors working alongside housing associations to bring in new capital to the sector. This could be through development-focussed JVs, stabilised assets, or a mixture of the two, but there is plenty of scope to structure a partnership to fit the needs of both organisations.

There is more at play than just capital funding though – housing associations benefit from a wealth of experience, local knowledge and tremendous operational capability, whilst investors can share their financial and structuring acumen to achieve a whole that is better than the sum of its parts.



### Case study M&G Real Estate and Hyde Housing

A new partnership to build over 2,000 high quality, sustainable shared ownership homes, with an initial investment of £61m to purchase 422 homes in London and Kent. The deal was negotiated during the Covid-19 pandemic and announced in March 2021.

This is direct response to the funding challenges faced by housing associations to ensure that existing homes are safe and sustainable and meet all the requisite safety requirements and the Government's Net Zero carbon agenda.

The collaboration will enable M&G, investing through their newly formed For-Profit Registered Providers, to buy existing stock and fund much of Hyde's shared ownership development pipeline, which in turn allows Hyde to recycle capital into new homes and other affordable housing initiatives. Through the partnership, Hyde have retained the property management responsibilities for the stock.

Both companies took significant time to ensure that they were aligned in their objectives to accelerate delivery of sustainable and affordable homes whilst seeking to improve customer services.





# The opportunity

The entrance of institutional investment into the UK's affordable housing sector can enable a step change in overall supply.

**The sector does not have the capacity to build the 145,000 homes per annum required to meet housing need – in its current form.**

In this paper, we have considered the scale of the supply challenge in affordable housing, viewed through the lens of the three elements of production: equity, debt and subsidy and we have investigated the availability and scalability of each.

Extrapolating the global accounts of registered providers forward in time, our modelling suggests that the not-for-profit sector in its current form, could deliver a theoretical maximum of **77,000** new affordable homes per annum.

Overlaying that with the unique set of headwinds faced by the sector, in particular fire safety and major repairs to existing stock and the need for capital investment on the journey to meet Net Zero Carbon requirements, will reduce the capacity of the sector. We estimate the realistic capacity of the not-for-profit sector is closer to **65,000** homes per annum.

This is well short of the 145,000 affordable homes required and a serious change in the capital funding model of the sector is needed to make a step change in affordable housing supply.



**Whilst debt is readily available, supply cannot be increased without increasing the availability of both subsidy and equity**

Of the three factors of production, only debt is readily available. The capital markets are very willing to lend to the sector, however the sector is already close to its borrowing limits.

Our analysis estimates that the sector currently consumes £5.1bn of subsidy per annum. Increasing the number of homes provided to 145,000 per annum and tilting the tenure mix towards social rent, as recommended by sector commentators, will require an additional **£14.2bn** of subsidy per annum. This could be reduced by **£2bn** through a new long-term rent settlement to 2035.

**Subsidy is provided to the sector in many ways, such as S106 planning obligations and tax reliefs, and there is a strong public return for investment.**

Government policy has been helpful in recent years, with larger capital funding in the Affordable Homes Programme and a long-term rent settlement, however these will need to be scaled up to meet the housing need.

**Institutional investors have strong appetite to inject new equity funding into the sector**

The amount of private capital in the sector has grown exponentially in recent years, with the estimated market size growing to over £2.2bn as of 2019. Research from Savills forecast the level of **private investment will grow to £23bn by 2026, enough to fund 130,000 new affordable homes.**

Some institutional investors already own For-Profit Registered Providers (Legal & General, M&G, Grainger) and have a considerable number of homes under management – comparable to some traditional housing associations.

The nature of the capital available varies with the nature of risk undertaken (e.g. development exposure), but investors can also bring additional resources to the table using their expertise in other asset classes and operational platforms and extremely strong risk and governance structures.

Due to the scale of the challenge here, it's important that investors approach this with an open mind.



**Institutional investors:**

**1. Increase capital allocations**

Bring forward a greater allocation of long-term capital to support the sector as part of a diversified investment portfolio.

**2. Maintain a flexible approach**

Structure partnerships that would work for all parties and matching to the appropriate source of capital (e.g. development risk, or stabilised assets).

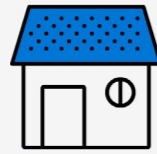
**3. Cross-pollinate from other sectors**

Institutional investors typically have a wealth of experience in adjacent sectors and can bring that to the table to aid new ventures.

## Housing associations can work in innovative partnerships with institutional investors

We have outlined a few models through which institutional investment can be levered to increase affordable housing supply. This could be through direct investment by For-Profit Registered Providers into new stock or working in tandem with existing housing associations through development joint ventures and existing stock acquisitions.

Looking ahead, these models need to be developed further and housing associations can consider what role they can play to unleash private capital to boost affordable housing supply:



### Housing associations:

#### 1. Partnership models

Consider which models work best for the delivery of additional affordable housing and assist in achieving their other organisational goals.

#### 2. Share affordable housing expertise

Utilise their decades of experience and knowledge in affordable housing development, management to provide new high-quality affordable homes.

#### 3. Find alternatives to mergers

Weigh up partnership with institutional investors as a potentially more productive alternative to merging two capital constrained entities together.

These models are just the tip of the iceberg, with socially-minded institutional investors keen to develop suitable models that work best for needs and objectives of their partners in order to deliver the step change in supply needed.

## Government policy can support and facilitate private capital to drive the step-change needed in supply

Changes to legislation in 2008 have opened the door for institutional capital to invest in affordable housing via For-Profit Registered Providers. Growth in the number of these entities has exploded in recent years, with an exponential rise in homes owned.

This has been well supported by Government to date, through initiatives such as the opening up of Strategic Partnerships to For-Profit Registered Providers in the latest grant programme to increase accessibility to grant funding. However, there is room to do more to create a more encouraging environment for private capital to enter the sector:



### Government:

#### 1. Review the subsidy provision

Increasing subsidy levels by £9bn - £14bn to support the delivery of 145,000 new affordable homes per annum in conjunction of a review of targeting subsidy provision. This could be through increasing grant levels, or supporting new delivery models.

#### 2. Rent settlement

Longer term rent settlements will provide investors with reassurance to spur activity, reduce the amount of risk capital required for investment and lower the subsidy requirement per unit.

#### 3. Create a level playing field

Review treatment of For-Profit Registered Providers (e.g. tax positions, grant uplift treatment) to remove obstacles for closer collaboration between institutional investors and housing associations.

It is well-established that investment on housing generates a multiplier effect through increased economic activity and employment. Investment in affordable housing goes one step further by lowering the overall housing benefit bill and reducing the negative externalities of poor housing. There is a strong argument for a public return on subsidy, in addition to meeting a fundamental societal need.

As this paper shows, delivering a step change in affordable housing will require an increase in subsidy provision to unleash the equity that institutional investors are willing, and able to provide.





# Glossary

## **Affordable Homes Programme**

Primary Government scheme for new affordable housing, providing capital grant funding. Current programme runs from 2021-2026.

## **Affordable housing**

Housing for sale or rent, for those whose needs are not met by the market (including housing that provides a subsidised route to home ownership and/or is for essential local workers).

## **Affordable rent**

Homes provided for rent at no more 80% of open market rent (inclusive of service charges).

## **G15**

Organisation of the largest housing associations in and around Greater London, which collectively are responsible for managing in the region of 600,000 homes.

## **Homes England**

Government's housing accelerator responsible for the funding of new affordable housing in England.

## **Housing associations (HAs)**

Private, not-for-profit organisations providing low-cost affordable housing for those in need. All housing associations are regulated by the Regulator of Social Housing.

## **Housing benefit**

Welfare benefit to assist people on low incomes to rent housing, in the process of being replaced by Universal Credit.

## **Institutional investors**

A company or organisation that invests money on behalf of clients and/or members, including pension funds and insurance companies.

## **Low cost homeownership**

Housing provided for sale that provides a route to ownership for those who could not achieve home ownership through the market. It includes shared ownership, relevant equity loans, other low-cost homes for sale and rent to buy (which includes a period of intermediate rent).

## **National Housing Federation (NHF)**

National Housing Federation, the trade association representing providers of affordable housing in England.

## **Registered providers (RPs)**

Organisation registered with the Regulator of Social Housing to provide affordable housing. Registered Providers can be not-for-profit (i.e. housing associations) or for-profit (For-Profit Registered Providers).

## **Regulator of Social Housing (RSH)**

Regulator of Social Housing, regulates providers of affordable housing.

## **S106**

Homes required to be provided as affordable housing under planning regulations.

## **Shared ownership**

Part-buy, part-rent product where the buyer pays a % share of the market value of the property and enters into a lease agreement with the landlord for the remainder. The buyer pays rent on the unowned portion and has the ability to staircase and purchase additional share of the property.

## **Social housing**

(See Affordable housing)

## **Social rent**

Homes made available at rent levels that are set in accordance with the Regulator of Social Housing's Rent Standard. Typically, 60% of market rent.

## **Universal credit**

Single payment to assist eligible individuals with their living costs, combination of previous benefits such as housing benefit, Income Support and Jobseeker's Allowance.





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**Simon Century**  
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Simon Century joined Legal & General in 2016. As Managing Director of Housing, Simon is responsible for leading direct investments into Legal & General's long-term residential housing sectors. In 2018 he founded Legal & General's wholly-owned affordable housing business, Legal & General Affordable Homes and in 2020 Legal & General's new single family housing business. In addition, he is responsible for Legal & General's growing principal investment portfolio across other residential platforms including investments into the Urban Build to Rent and Later living sectors.

Simon's career has spanned residential real estate, corporate finance and corporate strategy. He joined from the affordable housing provider, bpha where he was an executive committee member responsible for strategy and corporate finance. Prior to bpha, Simon worked at the advisory and investment firm, TradeRisks, advising clients in the infrastructure and quasi-Government sectors.

Simon is a full Member of the Association of Corporate Treasurers and holds the Certificate in Investment Management from the Chartered Institute for Securities & Investment.



**Jayson Parmar**  
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Jayson focusses on the investment strategy of Legal & General's direct investment into long-term residential housing, with a particular emphasis on the Affordable Housing and Build to Rent, identifying opportunities for expansion into adjacent sectors.

Prior to joining Legal & General, Jayson worked at London-based asset manager Cheyne Capital on the UK's first real estate impact fund deploying institutional capital to create new affordable housing and deliver additional social impact.

## About Legal & General



Established in 1836, Legal & General is one of the UK's leading financial services groups and a major global investor, with international businesses in the US, Europe, Middle East and Asia. With almost £1.3 trillion in total assets under management\*, we are the UK's largest investment manager for corporate pension schemes and a UK market leader in pension risk transfer, alternative asset origination, life insurance, workplace pensions and retirement income. Through inclusive capitalism, we aim to build a better society by investing in long-term assets that benefit everyone.

Legal & General has invested over £29bn in levelling-up regional economies, including through major UK-wide regeneration schemes and has recently made a commitment to enable all its new homes to operate at Net Zero carbon emissions from 2030.

\*As of June 2021

## About BPF



The British Property Federation is the voice of the UK real estate industry. We work with our members to help the real estate industry grow and thrive – to benefit business and society.

Our membership reflects the diverse nature of our industry – property owners, developers, funders and investors, agents, and advisers. Their investments help drive UK economic success, provide essential infrastructure, and create great places that people can call 'home'.

## Contact us

For further information about this paper, please visit [landg.com/moreaffordablehomes](https://landg.com/moreaffordablehomes).